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Hold-up, stakeholders and takeover threats

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Abstract

We analyze the impact of takeover threats on long-term relationships between the target owners and other stakeholders. In the absence of takeovers, stakeholders' bargaining power increases their incentive to invest but reduces the owners' incentive to invest. The threat of a takeover that would transfer value from the stakeholders reduces their ex ante investment. However, the stakeholders may appropriate ex post some value created by a takeover. This can prevent some value-enhancing takeovers. We examine extensions to the disciplinary role of takeovers, takeover defense mechanisms, and trade credit, and discuss empirical predictions.
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1. Introduction

Over the past decades, the costs and benefits of an active market for corporate control have been hotly debated. Most finance scholars argue that takeover activity is accompanied by operating and financial synergies, improved managerial discipline, more flexibility in internal capital markets, and a greater use of tax gains. Others argue that takeover threats lead managers to make myopic investment decisions, lead firms to suffer disadvantages from

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corporate diversification, and prevent firms from entering implicit contracts with workers.[1] This paper reexamines the merits of the market for corporate control in a framework that embeds explicitly strategic interactions among stakeholders.

We focus on the long-term interactions among an incumbent manager, a potential acquirer, and a long-term stakeholder.[2] We identify two conflicting effects: On the one hand, takeovers that are expected to hurt particular stakeholders will reduce their ex ante investment in the firm. On the other hand, where stakeholders stand to gain from a takeover (by appropriating a fraction of the value created), value-increasing takeovers may not take place. We discuss our results in light of existing empirical evidence, and we provide further empirical predictions about the effect of the possibility of a takeover on trading partners (including trade creditors) and workers. In particular, we suggest that stakeholder theories may be better tested on stakeholders other than workers because the relationship of the firm with these other stakeholders involve fewer outside contingencies than its relationship with workers.

Our approach to a theory of takeover threats and stakeholder relationships draws on insights found in the literature on incomplete contracts and the hold-up problem.[3] For simplicity, we first deliberately focus on a situation where a project depends primarily on a single stakeholder's investment, and where the only other investment is the costly takeover made by the bidder. We consider the special case where an entrepreneur runs a project whose future returns increase as the stakeholder exerts more effort. We suppose that this long-term relationship is governed by a sequence of short-term contracts. With long-term contracts ruled out, the expected negotiation of future short-term contracts affects ex ante investments. We start with the benchmark world of no takeovers. In this world, the entrepreneur may be better off ex ante with low ex post bargaining power: The stakeholder's bargaining power enhances his investment, as he expects to benefit more from this investment in future negotiations. In Section 5, we allow the entrepreneur to invest, and the stakeholder's investment is interpreted as financing the entrepreneur's investment. Then,

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[1] See, among many others, Agrawal and Jaffe (2003), Garvey and Gaston (1997), Garvey and Hanka (1999), Giammarino et al. (1997), Grinblatt and Titman (2001, Chapter 20), Jensen (1986, 1988), Morck et al. (1990), Scherer (1988), Shleifer and Summers (1988), and Stein (1988).

[2] At least three types of such stakeholders, apart from owners, can be affected by the possibility of a takeover: Debtholders, trading partners, and insiders, including managers and workers. A takeover can have many effects on these stakeholders, and the prospect of a takeover can alter the terms of the relationships among them. For instance, a takeover that leads to a change in capital structure will impact creditors. The prospect of a takeover threat will therefore affect the interest rate that creditors require. The takeover may also affect the company's market power and future supply contracts. The level of relationship-specific investment undertaken by the trading partners will also depend on the possibility of a takeover. The level of firm-specific investment made by workers, be it effort or temporary wage concessions, will also depend on the possibility of a takeover and the potential impact on future wage negotiations. To date, the existing literature on takeovers and stakeholders has focused on labor (Shleifer and Summers, 1988; Pontiff et al., 1990; and Rosett, 1990). By incorporating a more general set of stakeholders, we are able to provide a framework that integrates scattered theories of the real effects of takeover activity.

[3] The hold-up problem arises when a party who privately incurs the cost of an investment, but only obtains a fraction of the return generated by this investment, is thus led to underinvest. The analysis of this problem has been a popular proxy for transaction costs in modern theories of the firm (see, among many others, Grossman and Hart, 1986 and Tirole, 1999), as well as in the theoretical analysis of industrial relations (Grout, 1984).

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